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In the Supreme Court of the United States

OCTOBER TERM, 1984

AWECO, INC., AND UNITED-AMERICAN CAR CO.,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals in this bankruptcy case erred in remanding for further factual findings to determine whether a proposed distribution of assets in settlement of a general unsecured creditor's claim was "fair and equitable" to senior creditors.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A12) is reported at 725 F.2d 293. The opinions of the district court (Pet. App. B1-B10) and of the bankruptcy court (Pet. App. C1-C5) are not officially reported.

JURISDICTION

The judgment of the court of appeals (Pet. App. D1) was entered on February 21, 1984. A petition for rehearing was denied on April 23, 1984 (Pet. App. E1). The petition for a writ of certiorari was

filed on June 7, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This is a reorganization proceeding under Chapter 11 of the Bankruptcy Code (11 U.S.C.). Petitioner Aweco, Inc., is the debtor-in-possession. Petitioner United-American Car Co. (United) held an unsecured, unliquidated claim against Aweco for breach of contract (Pet. App. A2-A3). In 1981, Aweco, without having formulated a plan of reorganization for submission to its creditors, negotiated a settlement with United, agreeing to make an immediate payment of $5.3 million in satisfaction of the latter's unsecured claim (*ibid.*). Four parties, including the Internal Revenue Service, filed with the bankruptcy court objections to the proposed settlement.[1]

At the hearing, Aweco contended that approval of the settlement would enhance its prospects for successful rehabilitation. Its president testified that the key to the debtor's successful reorganization was the

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[1] The IRS held secured and priority tax claims against Aweco totalling approximately $6.1 million (Pet. App. A2). In addition, the IRS has recently completed an audit of Aweco and has filed an amended proof of claim asserting total tax liabilities exceeding $28 million. Other parties objecting to the proposed settlement were the Department of Energy, which holds an unsecured claim in the amount of $45 million based on a determination that Aweco overcharged its customers for oil; Sutton Investments, which holds a secured claim in the amount of approximately $7.6 million; and the Creditors' Committee. The Creditors' Committee withdrew its objection at the outset of the bankruptcy court hearing. Sutton withdrew its objection when the bankruptcy court subsequently granted it a lien on certain of Aweco's assets (Pet. App. A3-A4 n.5).

profitable operation of its chief asset, an oil refinery with a history of operating losses and in a currently deteriorating state (Pet. App. A4-A5). A court-appointed examiner estimated that Aweco would still have assets worth $30 million after the $5.3 million was distributed to United (*id.* at A5). His testimony, however, listed properties (including the refinery) totalling only $17.5 million in value (*ibid.*) The examiner did not know whether the refinery was encumbered by prior liens (*id.* at A10). The bankruptcy court approved the settlement at the close of this hearing, concluding in a brief opinion that the settlement was "fair and equitable" and was in the best interests of Aweco's creditors (*id.* at C3).

Upon the IRS' motion for reconsideration, the bankruptcy court held a second hearing, announcing at the outset that it had doubts about the value of the refinery (Pet. App. A5). Aweco changed its position at this hearing, indicating that it planned to sell the refinery rather than operate it (*id.* at A5-A6). The IRS' motion for a continuance to develop evidence about the refinery's value was denied (*id.* at A6), and the bankruptcy court again approved the settlement, this time without an opinion.

The district court affirmed (Pet. App. B1-B10). It reasoned that the proposed settlement would reduce Aweco's liabilities, that it would improve the likelihood of Aweco's rehabilitation under its plan of reorganization,[2] that the IRS' secured claim was adequately protected, and that the government would receive a fair share of Aweco's assets (*id.* at B5-B10).

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[2] The district court apparently was under the mistaken impression (see Pet. App. B9) that the bankruptcy court had approved a plan of reorganization in this case.

The Fifth Circuit vacated the district court's order and remanded the case to the bankruptcy court (Pet. App. A1-A12). The court of appeals held that the bankruptcy judge had abused his discretion in approving Aweco's settlement with a junior creditor absent reasonable assurance that the settlement accorded with the "fair and equitable" standard, *i.e.*, that priority of payment would be respected as to senior creditors who objected thereto (*id.* at A9). The court further held that the record did not present a sufficient factual foundation to permit a conclusion as to whether the "fair and equitable" standard had been met (*id.* at A10-A12).

ARGUMENT

Petitioners seek review of an interlocutory decision that does not preclude the possibility that they may prevail on remand. There is no need for this Court's intervention at the present stage of the case. In any event, the decision below is correct, there is no conflict among the circuits on the question presented, and there is no other basis for further review.

1. Petitioners' chief contention (Pet. 6-11) is that the court of appeals erred in applying the "fair and equitable standard" in the circumstances of this case. They concede (Pet. 9), as they must, that application of that standard would be proper if Aweco's settlement of United's claim were incorporated in a proposed plan of reorganization. The new Bankruptcy Code explicitly provides that a bankruptcy court may confirm a plan of reorganization over creditors' objections only "if the plan does not discriminate unfairly, *and is fair and equitable*, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan" (11 U.S.C. 1129(b)(1) (emphasis added)). The legisla-

tive history, moreover, makes clear that the term "fair and equitable" as used in Section 1129(b)(1) "codifies the absolute priority rule"—the bankruptcy rule of long standing that senior creditors have priority of payment over junior ones—"from the dissenting class on down." H.R. Rep. 95-595, 95th Cong., 1st Sess. 413 (1977). And this Court has held that bankruptcy courts have "the duty * * * to determine that a proposed compromise forming part of a reorganization plan is fair and equitable." *Protective Committee* v. *Anderson*, 390 U.S. 414, 424 (1968). See 6A *Collier on Bankruptcy* ¶ 11.06, at 222-223 n.55 (14th ed. 1977). Thus, if Aweco's proposed compromise of United's claim had been presented as part of a plan of reorganization, and if the IRS (as a senior creditor) had objected to the settlement in that context, the bankruptcy court plainly could have approved the settlement only by finding that the "fair and equitable" standard had been met.

Petitioners note, however, that Aweco proffered its settlement of United's claim *before* proposing a plan of reorganization, and contend that the court of appeals "erroneously graft[ed] the fair and equitable standard * * * onto pre-plan-of-reorganization compromises" (Pet. 10). This contention is wrong, as a matter both of precedent and of common sense. In *Protective Committee* v. *Anderson*, *supra*, this Court emphasized that "[c]ompromises are 'a normal part of the process of reorganization,'" that "[i]n administering reorganization proceedings in an economical and practical manner it will often be wise to arrange the settlement of claims as to which there are substantial and reasonable doubts," and that the requirement "that plans of reorganization

be both 'fair and equitable,' appl[ies] to compromises just as to other aspects of reorganizations" (390 U.S. at 424 (citing cases)). Although the compromise at issue there happened to be incorporated in one of many plans of reorganization proposed by the debtor, there is nothing in the Court's reasoning to suggest that the protection offered to senior creditors by the "fair and equitable" standard should hinge solely on the timing and context chosen by the debtor for submission of the compromise.[3]

Petitioners' argument is likewise at odds with common sense. As noted above, Congress plainly intended the "fair and equitable" standard to be applied, at the behest of objecting senior creditors, to settlements that are part of a reorganization plan. The content of a reorganization plan, however, as well as the timing of its submission, are largely in the debtor's control. On petitioners' theory, therefore, a debtor could deliberately postpone formulation of a plan, submit settlements of selected junior claims for approval,[4] and exhaust the estate's assets by distributions to those junior creditors before a plan of reorganization was even proposed. That result, obviously, would make the protection Congress intended to guarantee senior creditors by the "fair and equi-

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[3] There is thus no merit to petitioners' contention (Pet. 18-20) that the decision below conflicts with *Protective Committee* v. *Anderson, supra,* in applying the "fair and equitable" standard to settlements of the sort involved here.

[4] On petitioners' theory (Pet. 18-19), the bankruptcy court would be required to approve such pre-plan settlements provided only that they were fair as between the debtor and the settling party, regardless of the effect on other creditors of the resulting distribution of assets.

table" standard a hollow protection indeed.[5] The court of appeals thus correctly concluded that the "underlying policies" of the Bankruptcy Code mandate "a limited extension of the fair and equitable standard [such that] a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors" (Pet. App. A9).[6]

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[5] Petitioners suggest (Pet. 16-18) that there are other remedies to protect senior creditors, such as seeking dismissal of the reorganization proceedings or seeking to convert the case to a liquidating bankruptcy. See 11 U.S.C. 1112(b). Those remedies may well be appropriate where a debtor is systematically distributing its assets pursuant to piecemeal settlements of junior claims. But the existence of those remedies furnishes no basis for denying relief in the circumstances involved here, where a senior creditor would be injured by the distribution of a substantial portion of the debtor's assets to a single junior creditor.

[6] Petitioners correctly note (Pet. 8-9 & n.11) that Congress, in enacting the new Bankruptcy Code, intended to eliminate much of the inflexibility that had characterized proceedings under the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (previously codified in various sections of 11 U.S.C. (1976 ed.)). The flexibility Congress envisioned, however, did not include permitting debtors to eviscerate, in the manner petitioners propose, the protection afforded senior creditors by the "fair and equitable" standard. Congress did modify that standard in some respects, providing that it would apply only if senior creditors objected to the terms of the debtor's proposed reorganization, whereas under the 1898 Act the standard's application was mandatory even in the absence of senior creditors' objections. See H.R. Rep. 95-595, *supra*, at 222, 224. Congress likewise made clear that the "fair and equitable" standard did not apply to arrangements, which did not affect secured claims, for the obvious reason that senior creditors in such cases did not need the protection the standard affords. *Id.* at 222, 225,

2. Assuming that the "fair and equitable" standard applies to the settlement at issue, petitioners contend (Pet. 11-13) that the court of appeals erred in considering the liquidation value, as opposed to the going-concern value, of Aweco's assets in determining whether the standard was met, that is, in determining whether the proposed distribution to United would leave the estate with sufficient assets to satisfy senior claims. This contention is meritless. To begin with, the court of appeals, as petitioners recognize (Pet. 11), only "suggest[ed]" that liquidation value was the relevant figure. The court *held* that the record was inadequate to permit an informed decision about the settlement's "fairness" and "equity" (Pet. App. A12), without specifying what criterion the bankruptcy court should use to make that determination on remand.[7]

In any event, the court of appeals' suggestion was clearly reasonable on the facts presented. Congress intended to permit flexibility regarding the type of valuation to be used in reorganization proceedings,

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242, 250-251. See also H.R. Rep. 2320, 82d Cong., 2d Sess. 21 (1952); *SEC* v. *United States Realty & Improvement Co.*, 310 U.S. 434 (1940); 9 *Collier on Bankruptcy* ¶ 9.18[2.1] (14th ed. 1978). Since both of these modifications of the "fair and equitable" standard were consistent with continuing protection for senior creditors' rights, neither furnishes any support for petitioners' contention (Pet. 8-11) that the standard's application would be at odds with congressional intent here.

[7] At one point, petitioners appear to contend (Pet. 12) that Congress intended to dispense altogether with asset valuations in reorganization proceedings. But Congress fully appreciated that application of the fair and equitable standard "requires a full valuation of the debtor as the absolute priority rule [did] under [prior] law" (H.R. Rep. 95-595, *supra*, at 224).

adopting neither liquidation value nor going-concern value as an absolute test. H.R. Rep. 95-595, *supra*, at 224. In this case, Aweco proposed no plan to rehabilitate its operations, and its president testified (Pet. App. A6) that Aweco intended to sell rather than to operate the refinery that constituted its principal asset. Under these circumstances, the refinery's going-concern value is of no practical significance to its senior creditors, for it is the amount realized upon liquidation of the refinery that will affect the amount available for distribution to them in satisfaction of their claims. Thus, to the extent the opinion below can be read to support the use of liquidation value on remand, the opinion is correct.

3. Petitioners suggest (Pet. 4) that failure to uphold the instant settlement will hinder Aweco's successful rehabilitation. That argument assumes that Aweco would be required to pay United's claim in full unless the settlement were approved. Under the Bankruptcy Code's "cram-down" provisions, however, a plan of reorganization could be confirmed under which United (a junior unsecured creditor) would receive *nothing* for its claim, if Aweco's assets were inadequate to satisfy claims senior to United's. See 11 U.S.C. 1129(b); H.R. Rep. 95-595, *supra*, at 224.

Petitioners similarly contend (Pet. 13-15) that the decision below will hinder successful reorganizations by enabling a single senior creditor to block settlement of junior claims. But the "fair and equitable" standard that Congress adopted gives a single senior creditor precisely that power in the case of compromises incorporated in a reorganization plan. No policy of bankruptcy law supports a different result merely because the compromise is proffered (say) a few months before a plan is proposed. Congress did

not intend to promote the piecemeal distribution of a debtor's assets as a means of preferring junior creditors. Congress intended, rather, to foster the development of feasible plans of reorganization that respect creditors' relative rights.

4. Finally, there is no merit to petitioners' assertion (Pet. 18-21) that the decision below conflicts with the Eighth Circuit's decision in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (1984). That case involved the settlement of a dispute as to whether an escrow account belonged to the debtor in a Chapter 11 proceeding. Certain parties, who claimed to have been defrauded, contended that the escrow account belonged to them and hence was not properly an asset of the debtor's estate (730 F.2d at 1134). In partially affirming the settlement, the Eighth Circuit emphasized that the settlement did not determine the distribution of the debtor's assets to its creditors (*id.* at 1134-1135, 1139), and the court was thus not required to consider whether distributions from a bankruptcy estate pursuant to a settlement must meet the "fair and equitable" standard.[8] In this case, by contrast, Aweco proposed to distribute a substantial portion of its assets to a general unsecured creditor, without showing that the assets retained in the bankruptcy estate were sufficient to satisfy senior claims. The Fifth Circuit correctly applied the "fair and equitable" standard in these circumstances, and nothing in the Eighth Circuit's decision is to the contrary.

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[8] The Eighth Circuit did inquire whether the settlement was "fair, adequate and reasonable" in resolving the dispute concerning ownership of the escrow fund (730 F.2d at 1136-1138, 1139).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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